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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 905

ANCHOR COUPLING COMPANY, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (Pet. App. A1-A4) are not reported. The opinion of the court of appeals (Pet. App. A4-A14) is reported at 427 F. 2d 429.

JURISDICTION

The judgment of the court of appeals was entered on May 28, 1970. A petition for a rehearing *en banc* was denied on July 31, 1970 (Pet. App. A23). The

petition for a writ of certiorari was filed on October 27, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a payment made by petitioner in settlement of a state court proceeding for specific performance of an alleged contract for the sale of all of its assets was a deductible business expense or was, as the court below held, a nondeductible capital expenditure.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 162 and 263 of the Internal Revenue Code of 1954 and of Section 1.263(a)-2 of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, p. 11.

STATEMENT

In 1956, Charles L. Conroy and Walter Fritsch, petitioner's principal officers and shareholders, entered into negotiations with Borg-Warner Corporation concerning the possible sale of petitioner's assets to Borg-Warner. Borg-Warner proposed an agreement granting it an option to purchase petitioner's assets. Petitioner responded with a counteroffer, which Borg-Warner purported to accept. The parties continued their efforts to consummate the proposed transaction until August 1, 1956. On that date, Conroy raised objections to the proposed transaction and

subsequently refused to perform the purported contract.

On November 3, 1956, Borg-Warner filed suit in state court against petitioner, Conroy, and Fritsch, seeking specific performance of the alleged contract for the sale of petitioner's assets. Conroy and petitioner denied the allegations of the complaint; Fritsch admitted the allegations and asserted his belief that a valid contract of sale existed. The state trial court dismissed both the original complaint and a subsequent amended complaint on the ground that they did not allege a completed contract capable of specific performance. On appeal the Illinois Supreme Court reversed, holding that the amended complaint alleged facts that would support a finding of a valid contract of sale, and remanded the cause for trial. *Borg-Warner Corp.* v. *Anchor Coupling Co.*, 16 Ill. 2d 234, 156 N.E. 2d 513.

The trial on remand began on May 24, 1961, and was adjourned for the summer after two days of testimony. During the summer, settlement discussions were conducted and in October a settlement was reached. Under its terms; Borg-Warner dismissed its suit and released its claims against petitioner in return for $1,000,000, of which petitioner paid $600,000.

On its income tax return for fiscal 1962, petitioner deducted the $600,000 payment as an ordinary and necessary business expense under Section 162(a) of the Internal Revenue Code of 1954 (Appendix, *infra*, p. 11). The Commissioner disallowed the deduction

on the ground that the payment was an expenditure incurred in "defending or perfecting title to property" within the meaning of Section 1.263(a)-2(c) of the applicable Treasury Regulations (Appendix, *infra*, p. 11), which must be capitalized under Section 263 of the Code (Appendix, *infra*, p. 11). Petitioner paid the resulting deficiency, and, after its refund claim was denied, brought this suit for refund.

The district court sustained petitioner's claimed deduction, finding that the primary purpose of the $800,000 payment was "to free [petitioner] from the constraints imposed upon its business operations by the pendency of the litigation" (Pet. App. A2). The court of appeals ruled (Pet. App. A12) "that the origin and character of the claim with respect to which a settlement is made, rather than its potential consequences on the business operations of a taxpayer is the controlling test of whether a settlement payment constitutes a deductible expense or a nondeductible capital outlay." It accordingly concluded that since the origin of Borg-Warner's claim was Borg-Warner's alleged acquisition of petitioner's assets, and since the character of that claim, which involved Borg-Warner's right to receive those assets, was capital in nature, the settlement payment was a capital outlay not currently deductible.[1]

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[1] The factual setting is gleaned from the opinion of the court below (Pet. App. A4-A7) and from the opinion of the Illinois Supreme Court in *Borg-Warner Corp.* v. *Anchor Coupling Co.*, 16 Ill. 2d 234, 156 N.E. 2d 513.

ARGUMENT

The decision below is correct. There is no conflict or other reason for further review.

1. The court of appeals correctly held that the payment made by petitioner in settlement of Borg-Warner's suit for specific performance of an alleged contract for the sale of petitioner's assets was not deductible as an ordinary and necessary business expense under Section 162(a). The controversy between petitioner and Borg-Warner arose from Borg-Warner's alleged acquisition of title to petitioner's assets under a contract of sale. Indeed, in the state court litigation Borg-Warner asserted that it was the owner of those assets. In these circumstances, petitioner's settlement payment was made in defense of title and hence was a nondeductible expenditure. Treas. Reg. 1.263(a)-2(c) (Appendix, *infra*, p. 11); *American Dispenser Co.* v. *Commissioner*, 396 F. 2d 137 (C.A. 2); *Wise* v. *Commissioner*, 311 F. 2d 733 (C.A. 2); *United States* v. *Wheeler*, 311 F. 2d 60 (C.A. 5).

2. Petitioner's principal contention (Pet. 7-9) is that the decision below conflicts with this Court's decisions in *Woodward* v. *Commissioner*, 397 U.S. 572, and *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580. There is no merit to this contention. In these cases, the Court held that legal fees and other expenses incurred in connection with an appraisal proceeding to fix the value of dissenting shareholders' stock are part of the cost of acquisition of the stock and, therefore, must be treated as nondeductible capital outlays. As petitioner acknowledges (Pet. 7-

9), *Woodward* and *Hilton*, unlike this case, did not involve the treatment of costs incurred in the defense or perfection of title to property.

In concluding that the expenditures in *Woodward* and *Hilton* were capital expenditures, the Court rejected as inapplicable under the circumstances presented the so-called "primary purpose" test which petitioner here urges. Relying on its earlier decision in *United States* v. *Gilmore*, 372 U.S. 39, the Court reasoned that the origin and character of the claim litigated, not the consequences of the litigation and the taxpayer's motives or purposes in undertaking the litigation, are determinative of whether an expenditure is to be capitalized or expensed. The analysis and conclusion of the Seventh Circuit in this case are completely consistent with this rationale.

Petitioner argues, however, that in *Woodward* and *Hilton*, the Court rejected the "primary purpose" test only as applied to the acquisition or disposition of property, and recognized (397 U.S. at 577) that that test "may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly * * *." This observation cannot be read as an endorsement of the "primary purpose" test in the situation described, as petitioner would have it. At most, the Court's statement suggests that the question of the applicability of the "primary purpose" test under such circumstances was left open. And, given the Court's expression of dissatisfaction with the test (397 U.S. at 576-578), petitioner surely is incorrect in assuming that the Court would apply

it, in preference to the "origin and character" test, where, as in this case, the very transaction from which the claim against petitioner's property arose involved title to that property, not merely "more or less indirectly," but as directly as could be conceived. The decision below thus does not conflict in substance or in principle with the holdings in *Woodward* and *Hilton*.

3. Likewise incorrect is petitioner's claim (Pet. 9-10) that the decision below "conflicts with a long line of decisions of the Supreme Court allowing the deduction of expenditures arising from business litigation." Those cases involved wholly different factual situations in which deductions were claimed for expenditures which had their origin in current, day-to-day operations. In contrast, the present case involves expenditures arising directly from petitioner's efforts to sell all of its assets, and were incurred to defend against Borg-Warner's assertion of equitable title to those assets. In no sense do they represent the "current" costs of petitioner's manufacturing operations.

4. Contrary to petitioner's assertion (Pet. 11-12, 14-15), the ruling in this case does not conflict with the decisions of other circuits and the Court of Claims. *Rassenfoss* v. *Commissioner*, 158 F. 2d 764, like the instant case, was decided by the Seventh Circuit. In *Industrial Aggregate Co.* v. *United States*, 284 F. 2d 639, the Eighth Circuit specifically found (*id.* at 646) that the result there would be the same whether the case was approached from the standpoint of the origin and character of the claim asserted or the tax-

payer's purpose in defending it.[2] In *Ditmars* v. *Commissioner*, 302 F. 2d 481 (C.A. 2), the issue was whether an expenditure was a business or personal expense. *Brown-Forman Distillers Corp.* v. *United States*, 132 F. Supp. 711 (Ct. Cl.), unlike the instant case, did not involve expenditures incurred in the defense of an adverse claim to the taxpayer's property. Moreover, that case was decided long before this Court approved the "origin and character" test in *Gilmore*, *Woodward* and *Hilton*.[3]

5. Petitioner further contends (Pet. 13-16) that the Seventh Circuit's holding is at odds with various authorities permitting a deduction for expenditures incurred in connection with abandoned sales negotiations. But in the present case the parties did not mutually abandon their negotiations, as was true in the authorities cited by petitioner. On the contrary, Borg-Warner contended at all times that a valid contract resulted from its negotiations with petitioner, and, when petitioner refused to execute the contract, brought suit for specific performance. Only upon petitioner's settlement payment was Borg-Warner willing to relinquish whatever rights it had to petitioner's assets. The settlement payment thus

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[2] In a decision subsequent to *Woodward* and *Hilton*, the Eighth Circuit required capitalization of expenditures incurred in connection with litigation concerning title to corporate stock under the terms of a stock purchase agreement. *Helgerson* v. *United States*, 426 F. 2d 1293.

[3] The Tax Court cases upon which petitioner relies (Pet. 11-12, 14-15) also are distinguishable on their facts, but, in all events, raise no conflict warranting review by this Court.

cannot properly be characterized as a cost of abandonment of a proposed transaction, but must be considered a cost of defending title to property, as the court below held.

6. Finally, there is no merit to petitioner's contention (Pet. 17-19) that the court of appeals substituted its own factual findings for those of the district court. The facts of this case are essentially undisputed, and the court below accepted without question the findings of the district court.[4] In reversing, the Seventh Circuit held only that the district court had applied an erroneous legal standard to the undisputed facts—instead of looking to the origin and character of the claim against petitioner, it focused on petitioner's subjective purposes and the consequences to petitioner flowing from the dispute with Borg-Warner. The application of a legal standard to essentially undisputed facts is, in these circumstances, a question of law, fully reviewable on appeal. See *Trust of Bingham* v. *Commissioner*, 325 U.S. 365,

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[4] The district court found (Pet. App. A1) that "[a]t no time did Borg-Warner question the validity of Anchor's title to its assets." This finding is quite proper as far as it goes—but it does not comprehend or speak to the nature of Borg-Warner's claim. Although Borg-Warner did not question petitioner's ability to convey a valid title, the gist of its complaint against petitioner was that the alleged contract conveyed to it equitable title to all of petitioner's assets, and that petitioner was therefore obligated to complete performance of the contract by transferring to Borg-Warner legal title to the assets. The court of appeals did not disturb the district court's finding but rather gave proper legal effect to the fact that petitioner's expenses in defending this litigation originated in Borg-Warner's claim that title to the assets should be conveyed to it.

370; *Ruoff* v. *Commissioner*, 277 F. 2d 222, 229 (C.A. 3). Cf. *American National Bank of Austin* v. *United States*, 421 F. 2d 442 (C.A. 5), certiorari denied, October 12, 1970, No. 168, this Term; *Union Planters National Bank of Memphis* v. *United States*, 426 F. 2d 115 (C.A. 6), certiorari denied, October 12, 1970, No. 331, this Term.[5]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1970.

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[5] In its petition for rehearing, petitioner argued that if its settlement payment was a capital expenditure, as the court below held, it was entitled to allocate the payment to its various assets and thereby increase its subsequent deductions for depreciation and similar expenses. Although its claim for refund and complaint were sufficiently broad to encompass such an argument, petitioner apparently abandoned this claim at trial when it failed to come forward with specific evidence to support a proper allocation of the settlement payment. It raised the issue in the court of appeals only in its petition for rehearing and did not mention the issue in its petition for certiorari. While petitioner's failure of proof precludes any allocation for the taxable year here in question, petitioner would not be barred by res judicata or collateral estoppel from raising the allocation issue in later years not closed by the statute of limitations.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * *

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

* * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

Sec. 1.263(a)-2 *Examples of capital expenditures.*

The following paragraphs of this section include examples of capital expenditures:

* * * *

(c) The cost of defending or perfecting title to property.

* * * *

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